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No. 84-201

In the Supreme Court of the United States

OCTOBER TERM, 1984

AUGUST URBANEK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Petitioners challenge the court of appeals' decision upholding a method used by the IRS to allocate the cost of a condominium project between the part of the project that was sold (the dwelling units and amenities) and the part that was leased (the surrounding land). The decision below is correct, the question presented is basically factual, and there is no conflict among the circuits or other consideration warranting this Court's review.

1. Petitioner is a 50% partner in a partnership that developed a condominium complex in Florida.[1] A local density ordinance required that the entire tract of land, consisting

[1]Petitioner filed a joint federal income tax return for the tax year at issue (1972) with his wife, who died in 1977. Petitioner accordingly instituted this suit in both his individual and his representative capacities.

of 5.5 acres, be dedicated to the condominium project (Pet. App. 45, 47-48). The partnership constructed two condominium towers on a 0.9-acre plot in the middle of the tract. The surrounding 4.6 acres were used as an open park to support various amenities, including a parking lot, a putting green, a swimming pool and a marina (*id.* at 45-46).

The partnership sold a number of the condominium units during 1972. In each case, the buyer received fee simple title to his unit and a pro rata share of a package consisting of the land on which the towers were situated, the roads, and the amenities themselves (Pet. App. 46). The partnership retained title to the 4.6-acre tract on which the amenities were situated, and leased that land to the condominium association for 99 years at a yearly net rental of about $160,000, with periodic increases geared to inflation (*id.* at 46-47). The lease terms were negotiated at a time when the partnership controlled the condominium association. Each condominium buyer as a condition of his purchase agreed to pay his pro rata share of the $160,000 annual ground lease and pledged his unit as security for performance of that obligation (*ibid.*). Because of the local density ordinance, the land was useless to anyone but the condominium buyers (*id.* at 54).

In calculating its gain from the sale of condominium units during 1972, it was necessary for the partnership to allocate its aggregate cost for the project as between the units sold and the 4.6-acre tract, which (as noted above) was retained by the partnership and leased to the condominium association. In making that calculation, the partnership allocated almost all the project costs — the total cost of constructing the towers and amenities, the cost of the land on which the towers stood, promotional expenses, management fees, and so forth — to the condominium units (Pet. App. 49, 57). The partnership allocated to the surrounding 4.6-acre tract only the original cost of that land in its raw, or unimproved,

state (*id.* at 49). The effect of this allocation was to maximize the partnership's cost (or tax "basis") for the units sold and thus minimize the gain that was realized on the sale of those units.

The Commissioner on audit challenged this allocation. He took the position that the condominium development was a single, integrated project, that the building and the surrounding land contributed mutually to each other's worth, and that the total cost of the project should be allocated between the units and the 4.6-acre tract in proportion to their respective fair market values. The effect of the Commissioner's reallocation was to reduce the partnership's basis in the units sold and thus to increase the gain currently realized and currently subject to tax.[2]

Petitioner paid the deficiency in tax and sued for a refund in the Claims Court, which sustained the Commissioner's position (Pet. App. 42-65). The court found as a fact that the allocation of costs reflected on the partnership's tax return "[did] not reflect reality because the value of the lease — and the rent it commanded — reflected the expenses incurred on the project as a whole, not merely the cost of buying the land" (*id.* at 58). "Allocation of only the cost of the raw land to the lease," the court concluded, "was therefore entirely arbitrary" (*ibid.*). The court noted that the partnership had complete freedom —evidenced by its fixing of a $160,000 annual rental fee for the 4.6-acre tract — to manipulate the relative amounts of income it would derive

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[2]Conversely, the Commissioner's reallocation had the effect of increasing the partnership's tax basis in the retained 4.6-acre tract, the cost of which will be recovered by petitioner when the partnership ultimately sells or otherwise disposes of that property. The court of appeals, following the Claims Court, rejected petitioner's claim for depreciation deductions on the construction costs allocated to the leased land (Pet. App. 18-19), and petitioner does not challenge that holding here.

from selling the units on the one hand and from leasing the land on the other (*id.* at 56, 58). Under these circumstances, the court concluded, "[t]o permit [the partnership] to allocate expenses arbitrarily — without reference to the allocation of the incomes [it] has selected —can lead to a serious and unjustified distortion in the gains reported for tax purposes" (*id.* at 58-59).

The court of appeals affirmed, one judge dissenting (Pet. App. 1-35). It held that petitioner had failed to prove that the Claims Court's findings of fact with respect to the proper allocation of costs were "clearly erroneous" (*id.* at 8-9). It noted that the Commissioner has considerable discretion in making cost allocations of this sort (*id.* at 11). And sustained the Claims Court's finding that the Commissioner had not abused his discretion in determining that the project's cost should be allocated according to the respective fair market values of the units sold and the land retained, according to the formula set forth in *Welsh Homes, Inc.* v. *Commissioner*, 279 F.2d 391 (4th Cir. 1960).

2. The decisions below are correct. The Claims Court found, and petitioners do not dispute, that the partnership acquired, developed, and marketed the entire 5.5-acre tract as a single condominium project. As the trial court observed, "[t]he cash price for a unit plus the projected rental payments under the lease constituted an economic package which prospective buyers weighed as a whole" (Pet. App. 55). The partnership was thus relatively free to decide for itself what portion of its income would come from sale of the units (and thus be currently taxable) and what portion would come from rental of the 4.6-acre tract (and thus be tax-deferred). And just as the partnership's rental income and sales income were inextricably intertwined, so its various expenses "went towards making the entire project more marketable," with the result that it was "impossible to point to a particular expense and say it contributed to one

aspect of the project and not to another" (*id.* at 57). The evidence similarly "establishe[d] that it [was] impossible to value the 4.6 acres for purpose of sale or rental, except with reference to the project as a whole," since "no one other than the owners of the condominium units had any possible use for that land" (*id.* at 54 (footnote omitted)). In short, the expenditures that the partnership incurred "to improve the interest that was sold (namely, the condominium complex and the amenities) also materially enhanced the rentability of the leased interest [viz., the 4.6-acre tract], which could not have been rented at the rates set [$160,000 per year] but for such expenditures" (*id.* at 14). Because the condominium complex and the 4.6-acre tract were thus mutually interdependent, the court of appeals correctly sustained the Claims Court's finding that the partnership's allocation of almost all the project costs to the units, and of nothing but the cost of the raw land to the 4.6-acre tract, was "entirely arbitrary" (*id.* at 8-9).

The court of appeals also correctly sustained the Claims Court's conclusion that the project costs should be allocated according to the respective fair market values of the units sold and the land retained. Under this allocation method, first articulated by the Fourth Circuit in *Welsh Homes*, the total cost of a single project is allocated between that portion of the transaction which results in immediate income (here, the sale of the units), and that portion of the transaction which defers income (here, the 99-year leasehold), according to the fair market values of the two properties involved.[3] In the present case, the fair market value of the property sold is the sales price of the units, and the fair market value of the property leased is the capitalized value

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[3]In *Welsh Homes*, the taxpayer developed real estate and (as here) sold and leased various interests in the property as part of a package arrangement. The Fourth Circuit held that, in order to reflect income clearly for tax purposes, it was proper to aggregate the taxpayer's various project costs and then allocate that sum between the interest

of the $160,000 annual rental fee.[4] Application of this formula here ensures that the allocation of costs will correspond to the allocation of income selected by the partnership, which "was relatively free to set the price/rental ratio in making up the package [it] offered buyers" (Pet. App. 56).

3. Contrary to petitioner's assertions (Pet. 13-16), the courts below did not undertake to "restructure" the condominium sales transactions, and this case therefore has nothing to do with *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583-584 (1978). That case involved a three-party sale and leaseback transaction, and this Court said that "the Government should honor the allocation of rights and duties effectuated by the parties" (*id.* at 584). But the IRS in this case has not attempted to restructure the condominium sales transactions or to depart from "the allocation of rights and duties" effectuated by petitioner and the condominium buyers. Rather, the question here concerns petitioner's unilateral allocation of costs, as between the properties sold and retained, in computing the gain he realized on selling the units. It is well established that the Commissioner is not required to accept a taxpayer's artificial allocation of costs

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conveyed and the interest retained. Accord, *e.g.*, *E.I. DuPont de Nemours & Co.* v. *United States*, 471 F.2d 1211, 1220 (Ct. Cl. 1973). See *Biscayne Bay Island Co.* v. *Commissioner*, 23 B.T.A. 731, 735 (1931). Petitioner errs in contending (Pet. 19-20) that the *Welsh Homes* formula should be used only in cases involving Maryland ground rents. As the Claims Court stated (Pet. App. 61 n.12), the logic behind that formula does not "turn upon such fine points of local law," but "would appear to be applicable whenever a taxpayer singles out for separate treatment an integral portion of a transaction (i.e., a portion which has no market value apart from the project as a whole) and obtains for it rental income or other deferred compensation" (*id.* at 62 n.12).

[4]The parties below largely stipulated to the computation that would be called for if the *Welsh Homes* formula were adopted. See Pet. App. 15-16 n.5, 60 n.10.

in such situations, even though the underlying business transaction is otherwise valid. See, *e.g.*, I.R.C. § 446(b) (granting Commissioner discretion to change a taxpayer's accounting method if the taxpayer's method does not "clearly reflect income"); Treas. Reg. § 1.61-6(a) ("when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts").[5]

4. Finally, there is no merit to petitioner's contention (Pet. 27-34) that the court of appeals erred in consulting standard accounting treatises for guidance as to the proper allocation of condominium project costs. Although generally accepted accounting principles are not controlling for tax purposes (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979)), they are obviously relevant. Treas. Reg. § 1.446-1(c)(1)(ii). See *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 12 n.8 (1974) (citing standard accounting treatises as supporting Commissioner's reallocation of the taxpayer's basis in assets for depreciation purposes). Contrary to petitioner's assertion (Pet. 30), moreover, he had ample opportunity to present to the Federal Circuit his views regarding proper accounting practices, as the dissenting judge's opinions (Pet. App. 19-35, 40-41) make clear.

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[5]For similar reasons, petitioner errs in contending (Pet. 20-23) that the decision below conflicts with *Murry* v. *Commissioner*, 601 F.2d 892 (5th Cir. 1979). There, the IRS unsuccessfully sought to recharacterize future rental payments due on land surrounding a condominium complex as part of the proceeds of selling the units themselves, and sought to add the present value of those payments to the price actually paid by the condominium buyer in computing the seller's gain. Here, by contrast, the IRS contends, not that the lease payments should be recharacterized as sales proceeds, but that the costs of the project should be allocated on a different basis than that chosen by the taxpayer. There is thus no conflict between the two decisions.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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